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Supreme Court of the United States

KATHERINE KRAFT, Petitioner, —against— COMMISSIONER OF INTERNAL REVENUE, Respondent.	October Term, 1940 Petition and Brief No. 239

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF.

Supreme Court of the United States

KATHERINE KRAFT, Petitioner, —against— COMMISSIONER OF INTERNAL REVENUE, Respondent.	October Term, 1940 Petition No.

TO THE HONORABLE CHARLES EVANS HUGHES, CHIEF JUSTICE OF THE UNITED STATES, AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your petitioner respectfully shows:

I.

SUMMARY STATEMENT OF THE MATTER INVOLVED.

Petitioner originally petitioned the United States Board of Tax Appeals for a redetermination of a deficiency income tax assessed against her for the year 1934 (R., p. 3, et seq.). The Board of Tax Appeals affirmed the deficiency (R., p. 82). Upon petition to the United States Circuit Court of Appeals for the Third Circuit for a review of the decision of the Board of Tax Appeals (R., pp. 82-83), the decision of the Board of Tax Appeals was affirmed April 16, 1940 (R., p. 92).

The deficiency arose because of the Respondent attributing to the Petitioner the income of five separate trusts created by Petitioner in prior years, one in 1930 and the others in 1932, solely by reason of the provisions of Section 166 of the Rev-

enue Act of 1934 (R., p. 13). Respondent has never claimed that the Petitioner was taxable under Section 22(a) of said Revenue Act. The trusts were revocable by the settlor upon certain conditions hereinafter fully described (R., p. 73), and unless sooner terminated by revocation were to terminate upon the death of either the settlor or the beneficiary (R., pp. 15, 25, 35, 46 & 59). Upon termination the corpus was to go to the settlor or to her estate if her death was the cause of termination (R., pp. 16, 26, 36, 46 & 59). The Petitioner was not the trustee under the trusts nor had she any power over the disposition of the income, nor prior to the setting up of the trust or thereafter was the Petitioner under any legal duty toward any beneficiaries of the trust. The beneficiaries under the five trusts were Petitioner's (1) brother-in-law, (2) brother, (3) two sisters, (4) adult daughter and (5) adult daughter (see 5 Trust Agreements, beginning at the following pages of the Record, respectively, pp. 14, 24, 34, 45 & 58).

Paragraph "Second" of the trust for Charles A. Kraft provided as follows:

> "SECOND,—The party of the first part shall have the right by an instrument in writing executed under her hand and seal and served on the Trustees at least five days before the expiration of any calendar year, to revoke this trust after the end of any such calendar year; the intent hereof being that the trust hereunder shall continue from year to year unless the party of the first part revokes same after the end of any such year, but that said power of revocation shall not exist or be in the party of the first part at any time during any calendar year but that same shall arise or come into existence only after the end of any such calendar year, nor shall there be power to revest in the party of the first part any part of the corpus of this trust during any such calendar year, but that

the latter power shall arise and come into existence only after the end of such calendar year" (R., p. 73).

Paragraph "Second" of the trust for Clarence Conklin provided as follows:

> "SECOND,—The party of the first part shall have the right by an instrument in writing executed under her hand and seal and personally served on the Trustees or mailed to the said Trustees at their last known addresses, at least five days before the expiration of any calendar year, to revoke this trust, in whole or in part, after the end of any such calendar year; the intent hereof being that the trust hereunder shall continue from year to year unless the party of the first part revokes the same, in whole or in part, after the end of any such year, but that said power of revocation shall not exist or be in the party of the first part at any time during any calendar year and that same shall arise and come into existence only after the end of any such calendar year, nor shall there be power to revest in the party of the first part any part of the corpus of this trust during any such calendar year, but that the latter power shall arise and come into existence only after the end of any such calendar year, except, however, that on the death of the shortest lived of the party of the first part and CLARENCE CONKLIN, this trust shall terminate immediately" (R., pp. 73-74).

The trusts for Phoebe and Mary Conklin, Dorothy B. Kraft and Edna May Kraft contained a paragraph "Second" identical with paragraph "Second" of said trust for Clarence Conklin hereinbefore set forth, except as to the name of the beneficiary (par. 8 of Stipulation, R., p. 74).

No notice of revocation was served prior to December 26, in 1933, and therefore no such notice could be served so as

to revest either principal or income of the trusts in Petitioner prior to January 1st, 1935. The trusts were in force for the whole of the calendar year 1934 and the respective beneficiaries of said trusts were entitled to and received the income therefrom for the entire year 1934 (R., p. 74, par. 9).

Section 166 of the Revenue Act of 1932 (Appendix, p. 22) provided that the income of revocable trusts was taxable to the grantor if "at any time during the taxable year" the settlor had the right to revoke the trust. The 1932 Act was in effect until after the opportunity of the settlor to revoke the trust for the year 1934 had passed in December of 1933, and the 1934 Act was not in effect until May 10, 1934 (R., p. 6). In the 1934 Act the words "at any time during the taxable year", found in the 1932 Act, were left out of the corresponding Section 166 (App., p. 23).

The questions involved are whether the 1934 Act retroactively effected a tax upon Petitioner for the 1934 income from these trusts paid to the beneficiaries, and if so, whether such Act is unconstitutional for the following reasons:

(a) That to tax the income of the beneficiaries from said trusts to Petitioner would deprive Petitioner of her property without due process of law in violation of the Fifth Article of Amendments to the Constitution for the United States of America;

(b) That to tax the income of the beneficiaries from said trusts to Petitioner would be a taking of Petitioner's private property for public use, without just compensation in violation of the Fifth Article of Amendments to the Constitution for the United States of America;

(c) That to tax the income of the beneficiaries from said trusts to Petitioner would be so arbitrary, whimsical and capricious as to impose a burdensome tax upon your Petitioner for income irrevocably vested in other persons and which your Peti-

tioner never received, as to amount to confiscation of Petitioner's property in violation of the Fifth Article of Amendments to the Constitution for the United States of America;

(d) That to tax the income of the beneficiaries from said trusts to Petitioner is to lay a direct tax upon her without being in proportion to the census or enumeration directed to be taken by Article I, Section 2, Clause 3, and by Article I, Section 9, Clause 4 of the Constitution for the United States of America and which census or enumeration is under said Articles, Sections and Clauses a condition precedent to said direct tax.

The Petitioner has from the beginning of this case before the Commissioner, before the Board of Tax Appeals (R., pp. 7-8) and in the Circuit Court of Appeals (R., p. 83) raised and relied upon these Constitutional provisions.

II.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT:

I. The decision of said Circuit Court of Appeals, as to the application of Section 166 of the Revenue Act of 1934, by holding that the taxation of Petitioner for the income for the year 1934 of said trusts under said section does not deprive Petitioner of property without due process of law, does not take Petitioner's property for public use without just compensation and does not lay a direct tax upon Petitioner without being in proportion to the census or enumeration directed to be taken by Article I, Section 2, Clause 3 and by Article I, Section 9, Clause 4 of the Constitution of the United States of America:

(a) involves an important question of federal law which has not been but should be settled by this Court, i. e., a constitutional question.

(b) is the decision of a federal question in a way probably in conflict with applicable decisions of this Court.

II. The great importance of the income tax statute involved to the business world and to the legal profession and the need of an authoritative and elucidating decision as to the power of Congress to tax trust income to the grantor under an Act passed long subsequent to the time when the grantor had irrevocably given up for the year in question all power over not only the income itself, but also the corpus producing the income, especially when for a long period of time prior Acts specifically did not make such income taxable to the grantor.

WHEREFORE, your Petitioner prays that a Writ of Certiorari issue under the seal of this Court directed to the Circuit Court of Appeals of the Third Circuit demanding said Court to certify and send to this Court a full and complete transcription of the record and of the proceedings of said Circuit Court of Appeals had in the case numbered and entitled on its docket No. 7212, *Katherine Kraft, Petitioner vs. Commissioner of Internal Revenue, Respondent,* to the end that this case may be reviewed and determined by this Court as provided by the statutes of the United States; and that the judgment herein of said United States Circuit Court of Appeals for the Third Circuit be reversed by this Court, and for such further relief as to this Court may seem proper.

Dated, July 5th, 1940.

FRANK M. AVERY,
Counsel for Petitioner.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

SUPREME COURT OF THE UNITED STATES.

KATHERINE KRAFT,
Petitioner,

—against—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

I.

OPINION OF THE COURT BELOW.

The opinion in the Circuit Court of Appeals for the Third Circuit (R., pp. 88-91) was reported in 111 Fed. (2d) page 370 (C. C. A., 3rd Circuit, April 16, 1940). The opinion in the Board of Tax Appeals (R., p. 77) was reported in 40 B. T. A. , No. 44; C. C. H. Dec. 10774, July 18, 1939.

II.

JURISDICTION.

1. The date of the judgment to be reviewed is April 16, 1940.

2. The statutory provision which is believed to sustain the jurisdiction of this Court is Judicial Code, Section 240.

3. The facts, showing the nature of the case in rulings below are such as to bring it within the jurisdictional provision relied upon, are as follows:

Petitioner here was a party to this cause in the Circuit Court of Appeals for the Third Circuit (R., p. 91) which

Court has rendered a judgment affirming the decision of the Board of Tax Appeals (R., p. 91, fol. 93).

4. The cases believed to sustain said jurisdiction are as follows:

Helvering vs. Clifford, U. S. ; 60 S. Ct. 554, 84 L. ed. 504 (February 26, 1940);
Helvering vs. Wood, U. S. ; 60 S. Ct. 551, 84 L. ed. 511 (February 26, 1940).

III.

STATEMENT OF THE CASE.

This has already been stated in the preceding Petition under I, pages 1-5, which is hereby adopted and made a part of this brief.

IV.

SPECIFICATION OF ERRORS.

1. The Court erred in holding that Section 166 of the Revenue Act of 1934 should be so construed as to tax to Petitioner the income for the year 1934 from the trusts here involved.

2. The Court erred in holding that the taxing to Petitioner of the 1934 income of the five trusts here involved under Section 166 of the Revenue Act of 1934 did not (a) deprive Petitioner of her property without due process of law, (b) did not take Petitioner's property for public use without just compensation and (c) did not lay a direct tax upon Petitioner without being in proportion to the census or enumeration.

V.

ARGUMENT.

Point A.

The retroactive effect of a new tax statute taxing the Petitioner for the income of the Beneficiaries of the trusts here involved is an important question of federal law which has not been settled by this Court.

Point B.

The decision of the Circuit Court of Appeals for the Third Circuit in this case is the decision of a federal question in a way probably in conflict with applicable decisions of this Court.

POINT A.

THE RETROACTIVE EFFECT OF NEW TAX STATUTES TAXING THE PETITIONER FOR THE INCOME OF THE BENEFICIARIES OF THE TRUSTS HERE INVOLVED IS AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN SETTLED BY THIS COURT.

Section 1 of the Revenue Act of 1934 (App., p. 22) under which the deficiency is assessed specifically provides that the provisions of Title 1 of the Act shall apply only to the taxable years beginning after December 31, 1933. Said Act did not become a law, however, until May 10, 1934, so that it is retroactive for the period from May 10, 1934 to January 1, 1934.

Prior to the passage of the 1934 Revenue Act, and at all times since the trusts involved herein were created until May 10, 1934, similar provisions in the Revenue Acts in force during that period provided that the income of a trust was taxable to the grantor, where the grantor had the power to re-

vest in himself title to the corpus "at any time during the taxable year". Conversely, the income of such trusts was not taxable to the grantor where he did not have such a power "at any time during the taxable year" (Section 166, Revenue Act of 1928 (App., p. 22); Section 166, Revenue Act of 1932 (App., p. 22)).

The Revenue Act of 1934, Section 166, effective May 10, 1934, provides:

> "Where at any time power to revest in the grantor title to any part of the corpus of the trust is vested—(1) in the grantor * * * alone * * * then the income of such part of the trust shall be included in computing the net income of the grantor."

Section 166 of the 1934 Act differs only from the similar section in the 1932 Act, which later Act was in force at the time the one trust involved herein was amended and at the time when the other trusts were created, in that in the 1934 Act there was left out the words underlined in the following phrase from the 1932 Act:

> "Where at any time *during the taxable year* the power," etc.

Under the terms of the trusts involved here the notice of revocation of the trust for any succeeding year must be served on or before December 26 in any preceding year (R., p. 73). Therefore, to revoke any of the instant trusts for the year 1934, the notice must have been served on or before December 26, 1933. On this latter date all of the trusts had been in effect for over a year under a Revenue Act which did not tax the income of such trusts to Petitioner. On this latter date the Revenue Act of 1934 not only was not a law, its proposed provisions were not even within public knowledge. On December 26, 1933, therefore, no knowledge can be imputed to Petitioner that, under a new Revenue Act to

be passed six months later, the income from the trusts might be taxable to the Petitioner even though at the time such law would be effective she would have no power to procure for herself, by revocation of the trust, title to the corpus and the income from said trusts upon which she was going to be taxed. After December 26, 1933 Petitioner had no power, by revoking the trusts, or otherwise, to procure for herself in 1934 any part of the corpus or the income of the trust. The income from the trusts was beyond question the property of and payable solely to the beneficiaries of said trusts (Stipulation, par. 9; R., p. 74).

Petitioner admits that if she did not take the necessary steps to revoke the trusts for the year 1935, *et seq.*, the income from said trusts for 1935 would belong to the beneficiaries, but the Petitioner nevertheless would be taxable on the amount of said income for the year 1935 and subsequent years, under Section 166 of the Revenue Act of 1934, because she would have had the opportunity to procure for herself the income for 1935 and subsequent years but had elected not to do so. As to the 1934 income, upon which she is now being taxed, *the 1934 Act did not give her such opportunity.*

Petitioner, under the circumstances here, cannot be taxed for the income of others. To hold otherwise would render the section unconstitutional. (*Hoeper vs. Tax Commissioner of Wisconsin*, 284 U. S. 206.) Section 166 of the Revenue Act of 1934 should be held not to apply to the income of these trusts for the year 1934, but to apply to subsequent years, for it is a familiar rule of law that a statute, which would be unconstitutional as applied to a certain class of cases, and is constitutional as applied to another class, should be held to have been intended to apply only to the latter class. *United States ex rel. Attorney General vs. Delaware & Hudson Company*, 213 U. S. 366; *United States vs. Jin Fuey Moy*, 241 U. S. 394; *United States vs. Goelet*, 232 U. S. 293.

In *Lewellyn vs. Frick*, 268 U. S. 238, the Court said at page 251:

> "* * * Not only are such doubts avoided by construing the statute as referring only to transactions taking place after it was passed, *but the general principle 'that laws are not to be considered as applying to cases which arose before their passage' is preserved, when to disregard it would be to impose an unexpected liability that, if known, might have induced those concerned to avoid it,* and to use their money in other ways. *Schwab vs. Doyle*, 258 U. S. 529, 534, 66 L. Ed. 747, 752, 26 A. L. R. 1454, 42 Sup. Ct. Rep. 391." (Italics ours.)

Although it is true that this Court has on occasion held that a tax statute may be made retroactive so as to tax income for a period prior to the passage of the statute, yet it has never had before it a case where the retroactive provisions of the statute resulted in a tax to A based upon the income of B.

One of the latest cases in this Court on the extent to which a taxing statute may be retroactive is *Welch vs. Henry*, 305 U. S. 134, 83 L. ed. 87. There the Court had before it the constitutionality of a Wisconsin statute passed in 1935 taxing corporation dividends received in 1933. The Court, in approaching the problem, said at page 104 (L. ed.):

> "In the cases in which this Court has held invalid the taxation of gifts made and completely vested before the enactment of the taxing statute, decision was rested on the ground that the nature or amount of the tax could not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event. *Nichols vs. Coolidge*, 274 U. S. 531, 542, 71 L. ed. 1184, 1192, 47 S. Ct. 710, 52 A. L. R. 1081; *Untermeyer*

vs. Anderson, 276 U. S. 440, 445, 72 L. ed. 645, 647, 48 S. Ct. 353; (Citing *Blodgett vs. Holden*, 275 U. S. 142, 147, 72 L. ed. 206, 210, 48 S. Ct. 105); *Coolidge vs. Long*, 282 U. S. 582, 75 L. ed. 562, 51 S. Ct. 306. Since, in each of these cases, the donor might freely have chosen to give or not to give, the taxation, after the choice was made, of a gift which he might well have refrained from making had he anticipated the tax, was thought to be so arbitrary and oppressive as to be a denial of due process. But there are other forms of taxation whose retroactive imposition cannot be said to be similarly offensive because their incidence is not on the voluntary act of the taxpayer. And even a retroactive gift tax has been held valid where the donor was forewarned by the statute books of the possibility of such a levy, *Milliken vs. United States*, 283 U. S. 15, 75 L. ed. 809, 51 S. Ct. 324, *supra*. *In each case, it is necessary to consider the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation.*" (Italics ours.)

Although the majority opinion held the statute constitutional on the ground that, as Wisconsin could have taxed the dividends in 1933, it could well do so in 1935 and the Court could not assume that the stockholders would have refused to accept the dividends in 1933, if they thought they were to be taxed in 1935, there was a vigorous dissent by Mr. Justice Roberts, in which Justices McReynolds and Butler concurred, in which it was pointed out that what was said in *Milliken vs. United States*, 283 U. S. 15, 25, was peculiarly apposite to the facts in the *Welch* case. Justice Roberts said at page 109, referring to the *Milliken* case:

> "There (referring to earlier decisions) condemning, under the due process clause, retroactive taxes, it was

> stated: 'In both the point was stressed, as the basis of decision, that the nature and amount of the tax burden imposed could not have been understood and foreseen by the taxpayer at the time of the particular voluntary act which was made the occasion of the tax.' Here the nature and amount of this special and peculiar tax could not have been understood and foreseen when the petitioner paid his 1933 income tax."

From the language of both the majority and minority opinions in *Welch vs. Henry, supra,* it becomes apparent that where the tax imposed could not have been understood or foreseen by the taxpayer at the time of the act which brought about the tax, the Court will not hesitate to declare a retroactive taxing statute unconstitutional, particularly when the income taxed never was nor could be the income of the person taxed, nor used for his benefit. (*Hoeper vs. Tax Commissioner of Wisconsin,* 284 U. S. 206, 76 L. ed. 248.)

In the latter case, an income tax statute of Wisconsin taxed the husband for the joint and separate income of both husband and wife. The Court held that such law was unconstitutional, saying at page 251 (L. ed.):

> "Since, then, in law and in fact, the wife's income is in the fullest degree her separate property and in no sense that of her husband, the question presented is whether the state has power by an income tax law to measure his tax, not by his own income but, in part, by that of another. To the problem thus stated, what was said in *Knowlton vs. Moore,* 178 U. S. 41, 77, 44 L. ed. 969, 984, 20 S. Ct. 747, is apposite:
>
> > 'It may be doubted by some, aside from express constitutional restrictions, whether the taxation by Congress of the property of one person, accompanied with an arbitrary provision that the rate of tax shall be fixed with reference to the sum of the property of another, thus bringing about the pro-

found inequality which we have noticed, would not transcend the limitations arising from those fundamental conceptions of free government which underlie all constitutional systems.'"

In the case at bar, the income which has been arbitrarily taxed to Petitioner by the Respondent was in no sense income to the Petitioner under the instant trusts. Once a calendar year had started there was no power in the grantor of the trusts (Petitioner) to recall either principal or income from the trusts for that year. Petitioner's title to both principal and income was gone for the whole of such calendar year. The trustees held the legal title to the trust property and could not return such title to the grantor during the whole of such calendar year. The income from the trusts belonged to the beneficiaries for the whole of such calendar year. The beneficiaries had the right to go into the New York Supreme Court and compel the continuance of those trusts both as to principal and income for the whole of said calendar year, i.e., 1934 (Paragraph 9 of Stipulation; Record, p. 74). The instant trusts imposed no restraint on the beneficiaries' use of the income from said trusts. The beneficiaries could give away or squander the income and the Petitioner could do nothing to impose her will upon the use of this income. Therefore, to now tax the Petitioner for the income from trusts for the year 1934 under the provisions of Section 166 of the Revenue Act of 1934, enacted May 10, 1934, is to do a wholly arbitrary, whimsical and capricious thing.

In order to tax Petitioner on the income from said trusts there must be attributed to Petitioner the ownership of the principal or income from said trusts, whereas she had the ownership of neither for the whole of the year 1934. The grantor had nothing in 1934 which was equivalent to ownership nor was there anything approaching an equivalent to ownership. Here was divestment of title in a permanent and definitive way—permanent and definitive for the whole of 1934. The Petitioner had stripped herself for the whole of

1934 of every interest in the subject matter of the trusts. *The Petitioner had no opportunity to revoke, alter or amend these trusts for the year 1934 after the passage of said Section 166 on May 10, 1934, as she was bound to allow these trusts to continue through the whole of the year 1934.*

We have, therefore, an entirely different situation than was present in the cases now to be discussed.

In *Corliss vs. Bowers,* 281 U. S. 376, the Court held that the income from a trust revocable at any time created prior to 1924 was taxable to the grantor under the 1924 Revenue Act because the trust there amounted to nothing more than an assignment of income which belonged to the grantor and the trust was revocable at any time. The Respondent cannot seriously contend that the trusts involved here involved merely an assignment of income, and certainly the trusts were not revocable at any time during 1934.

Reinecke vs. Smith, 289 U. S. 172, 77 L. ed. 1109, was quite similar to the *Corliss* case, except that there was involved in the *Reinecke* case the necessity of the trustee joining with the settlor in revoking the trust. The Court held, however, that the trustee had no duty to resist revocation, and the case was the same as if the reserved right of revocation had been vested jointly in the grantor and a stranger to the trust.

The opinion of the Circuit Court of Appeals attempts to answer the constitutional question raised here by saying that the case of *Reinecke vs. Smith, supra,* disposes of this contention. In said opinion, it is stated (R., p. 90, fol. 92):

> "In the *Reinecke* case the taxpayer at all times retained the power to repossess the corpora. In the instant case the taxpayer at any time possessed the power to repossess the corpora. In the *Reinecke* case, as in the case at bar, the income sought to be taxed to the grantor had already been received by the cestuis and was not recoverable by the grantor. The measure of control retained by the grantor over the corpora of the trusts is within the literal language of Section 166

and we hold the application of the Section by the Commissioner to have been constitutional."

Certainly under the facts of this case the Circuit Court was in error in stating that the taxpayer at any time "possessed the power to repossess the corpora." It might have stated that "in the instant case the taxpayer at any time in 1934 possessed the power to repossess the corpora after 1934" which is the fact, but certainly the taxpayer did not possess the power to repossess the corpora for 1934 after December 26, 1933 had passed without a revocation of the trust. This is the essential difference between the instant case and the *Reinecke* case, in which latter case the taxpayer had the right at any time to repossess the corpora. It is respectfully submitted that the *Reinecke* case does not dispose of the constitutional question raised here.

In *Burnet vs. Wells*, 289 U. S. 669, 77 L. ed. 1439, the trusts were irrevocable but the income was to be used to pay insurance premiums on policies of insurance on the life of the grantor. The trust was set up in 1922, and under the 1924 Revenue Act it was provided that "Where any part of the income of the trust is or may be applied to the payment of premiums on policies on the life of the grantor * * * such part of the income of the trust shall be included in computing the net income of the grantor." The Court held that the grantor of the trust had, by the provisions of the trust, devoted the income therefrom to the preservation of his own contracts, and therefore the statute, although retroactive, was not so arbitrary and capricious as to be unconstitutional.

Certainly, in the instant case, Petitioner did not nor could not derive any benefit from the income of the trusts for the year 1934. The income was the income of the beneficiaries and not the Petitioner. To tax this income to Petitioner is to do what the Court in *Heiner vs. Donnan*, 285 U. S. 312, 76 L. ed. 772, condemned at page 779, saying:

"* * * Plainly, this is to measure the tax on A's property by imputing to it in part the value of the property

> of B, a result which both the *Schlesinger* and *Hoeper* cases condemn as arbitrary and a denial of due process of law. Such an exaction is not taxation but spoliation."

United States vs. Hudson, 299 U. S. 498, 81 L. ed. 370, involved the Silver Purchase Act of 1934 which put a special tax on the profit realized on the sale of silver bullion. It became a law on June 15, 1934 and the period of retroactivity prescribed for the taxing provisions reached back only to May 15, 1934. The Court pointed out that in that case there had been a forewarning regarding the nature of the tax to be imposed, therefore the retroactivity of the statute was not arbitrary or capricious. Furthermore, the profits from the silver were the profits *of the person taxed* as was the case in *Welch vs. Henry, supra.* As heretofore pointed out, that element is entirely lacking in the present case.

In *Shwab vs. Doyle,* 258 U. S. 529, 66 L. ed. 747, plaintiff's testatrix, a year before the passage of the 1916 Estate Tax Law, gave a million dollars to trustees in trust for others. She died six days after the passage of the act and her estate was taxed for the value of the gift. It was urged that the statute could have no retroactive effect upon the gift made. The Court said at page 534:

> "* * * The initial admonition is that laws are not to be considered as applying to cases which arose before their passage unless that intention be clearly declared. * * * But granting the contention of the defendant has plausibility, it is to be remembered that we are dealing with a tax measure, and whatever doubts exist must be resolved against it."

The Court held that the statute should not be

> "* * * construed to apply to transactions completed when the act became a law. And this, we repeat, is

> in accord with principle and authority. It is the proclamation of both that a statute should not be given a retrospective operation unless its words make that imperative, and this cannot be said of the words of the Act of September 8, 1916 * * *."

The judgment sustaining the tax was reversed.

In *Ochoa vs. Hernandez Y Morales,* 230 U. S. 139, 57 L. ed. 1427, the Court said at page 1437:

> "* * * Whatever else may be uncertain about the definition of the term 'due process of law,' all authorities agree that it inhibits the taking of one man's property and giving it to another contrary to settled usages and modes of procedure and without notice or an opportunity for hearing."

The cases cited in *Welch vs. Henry, supra,* in support of the statement that the contention that the retroactive application of the Revenue Acts is a denial of due process guaranteed by the Fifth Amendment has been uniformly rejected, were all cases where the statute taxed the income or the use of assets of the person taxed. In none of them was involved the taxation of A for the income of B.

In an article in a recent issue of the Harvard Law Review, Vol. 53, p. 1322, "Income Tax on Short Term and Revocable Trusts", the author states at p. 1331, under a note citing the instant case:

> "The constitutionality of the Section as amended apparently has not been questioned although in a situation wherein revocation requires several years advance notice, the grantor might well assert that he is being taxed on the income of another, contending such taxation to be violative of the due process clause (*C. F. Hoeper vs. Tax Commissioner of Wisconsin,* 284 U. S. 206)."

The constitutionality of Section 166 of the 1932 Revenue Act has been questioned and questioned consistently in this case before the Commissioner, the Board of Tax Appeals and the Circuit Court of Appeals. Why the author should state that in a case which required several years advance notice the grantor might raise the constitutional question is not clear. In this case the Petitioner had to give notice prior to 1934 and there would seem to be no difference in principle whether the notice had to be given in December of 1933 or December of 1932 or December of 1931.

To avoid unconstitutionality this Court should read said Section 166 as not applicable to the instant trusts *for the year 1934*, because of the doctrine laid down in *United States ex rel. Atty. Gen. vs. Delaware & H. Co.*, 213 U. S. 366, 407, 408. This case has been many times cited by the United States Supreme Court and stands for the proposition that as between two possible interpretations of a statute, by one of which it would be unconstitutional and by the other valid, it is the plain duty of the Court to adopt that interpretation which will save the act.

Words of a statute have been greatly strained in order to avoid such a construction as would make the statute unconstitutional.

United States vs. Jin Fuey Moy, 241 U. S. 394.

See also *Lucas vs. Alexander*, 279 U. S. 573, 73 L. ed. 851, where the Court said at page 854:

> "* * * In answering it, provisions of the taxing statute enacted as aids in arriving at the answer must be construed with an eye to possible constitutional limitations so as to avoid doubts as to its validity."

POINT B.

THE DECISION OF THE CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT IN THIS CASE IS THE DECISION OF A FEDERAL QUESTION IN A WAY PROBABLY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT.

For the reasons stated under Point A above, it is respectfully submitted that the decision of the Circuit Court of Appeals in this case is the decision of a Federal question in such a way as to be in conflict with the decision of this Court in *Hoeper vs. Tax Commissioner of Wisconsin*, 284 U. S. 206, which held that one person could not be taxed on the income of another and in *Eisner vs. Macomber*, 252 U. S. 189, which held that the 16th Amendment to the Constitution did not permit direct taxation of property without apportionment.

The income taxed here was the income of the beneficiaries of the trust. The tax of Petitioner is a tax on her principal, not her income and therefore in order to sustain a tax against Petitioner resort must be had to apportionment as set forth in *Eisner vs. Macomber, supra.*

CONCLUSION.

It is respectfully submitted, therefore, that this case is one calling for the exercise by this Court of its supervisory powers by granting a writ of certiorari and thereafter reviewing and reversing said decision.

FRANK M. AVERY,
Counsel for Petitioner.

APPENDIX.

Revenue Act of 1928.

Section 166. REVOCABLE TRUSTS. Where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction with any person not a beneficiary of the trust, the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor.

Revenue Act of 1932.

Section 166. REVOCABLE TRUSTS. Where at any time during the taxable year the power to revest in the grantor title to any part of the corpus of the trust is vested—(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or (2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor.

Revenue Act of 1934.

Section 1. APPLICATION OF TITLE. The provisions of this title shall apply only to taxable years beginning after December 31, 1933. Income, war-profits, and excess-profits taxes for taxable years beginning prior to January 1, 1934, shall not be affected by the provisions of this title, but shall remain subject to the applicable provisions of prior revenue acts, except as such provisions are modified by Title III of this Act or by legislation enacted subsequent to this Act.

Section 166. REVOCABLE TRUSTS. Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or (2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust shall be included in computing the net income of the grantor.

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No. 289

In the Supreme Court of the United States

OCTOBER TERM, 1940

KATHERINE KRAFT, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 77–81) is reported in 40 B. T. A. 240. The opinion of the Circuit Court of Appeals for the Third Circuit (R. 88–91) is reported in 111 F. (2d) 370.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 16, 1940 (R. 91–92). The petition for a writ of certiorari was filed July 13, 1940. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Petitioner, as grantor of five trusts, reserved the power to revest title to each corpus in herself after the end of any calendar year by an instrument served upon the trustees at least five days prior to the expiration of the year. She executed no such instrument during 1933 and received none of the trust income during 1934. Section 166 of the Revenue Act of 1934—the first specifically to tax such income to the grantor—was enacted in May 1934. The question is whether the income from the trusts during the year 1934 may constitutionally be taxed to the grantor.

STATUTE AND REGULATIONS INVOLVED

The applicable statute and regulations will be found in the Appendix, *infra*, pp. 7–11.

STATEMENT

The facts, as stipulated and found by the Board of Tax Appeals (R. 72–76, 77–81), are substantially as follows:

On or about November 20, 1930, and December 15, 1932, the petitioner, by instruments in writing, created five separate trusts for the benefit of certain named beneficiaries (R. 72, 73). The trust agreement in which Clarence Conklin is named as beneficiary of the income is typical of the other trust instruments (R. 73, 74). It reads in part as follows (R. 25–26, 73–74):

> SECOND,—The * * * [grantor] shall have the right by an instrument in writ-

> ing * * * served on the Trustees * * * at least five days before the expiration of any calendar year, to revoke this trust, in whole or in part, after the end of any such calendar year; * * *
>
> THIRD,—Upon the termination of this trust, all property and/or securities affected hereby shall belong absolutely to and shall vest immediately in the * * * [grantor] if she shall then be living, free and clear of any trust hereunder, * * * and if said * * * [grantor] shall then be dead, same shall belong absolutely to and vest immediately in the estate of the * * * [grantor] and same shall be distributed by the executors and/or administrators of the * * * [grantor] as part of her estate, free and clear and discharged of and from any trust hereunder, * * *.

No notice of revocation of any of the trusts was given by petitioner at any time prior to or during the calendar year 1933; such trusts were in full force and effect during the whole of the calendar year 1934, and the respective beneficiaries were entitled to and actually did receive the trust income during the year 1934 (R. 74–75).

The Commissioner of Internal Revenue determined that, under Section 166 of the Revenue Act of 1934, the income from the five trusts was taxable to petitioner, and asserted a deficiency in the amount of $9,731.84 (R. 75). The determination was sustained by the Board of Tax Appeals (R. 82); the court below affirmed (R. 92).

ARGUMENT

Petitioner concedes (Pet. 10–11), as she must,[1] that the measure of control retained by her as grantor brings the situation within the literal terms of Section 166 of the Revenue Act of 1934 (Appendix, *infra,* p. 7). Her only reason for urging that the judgment below be overturned is the alleged unconstitutionality of Section 166 as applied in the particular instance. The sole foundation for this charge is the circumstance that Section 166 was enacted by Congress (in May 1934) some five months after the expiration of the period (prior to December 26, 1933) during which petitioner could have exercised her right to revoke the trusts for the year 1934.

1. It may be observed, at the outset, that the sub-

[1] The reasons for this section, as set forth in the statement of the House managers in the Conference Report relating to the Revenue Act of 1934, clearly show an intention to tax such trusts (H. Rep. No. 1385, 73d Cong., 2d Sess., p. 24):

"Amendments nos. 96 and 97: Under existing law, the income from a revocable trust is taxable to the grantor only where such grantor (or a person not having a substantial adverse interest in the trust) has the power within the taxable year to revest in the grantor title to any part of the corpus of the trust. Under the terms of some trusts, the power to revoke cannot be exercised within the taxable year, except upon advance notice delivered to the trustee during the preceding taxable year. If this notice is not given within the preceding taxable year, the courts have held that the grantor is not required under existing law to include the trust income for the taxable year in his return. The Senate amendments require the income from trusts of this type to be reported by the grantor. The House recedes."

ject of the tax here is not the creation of the trusts or the initial transfer of the corpus, as in the case of taxes on gifts, but the income of the trusts which accrued after the effective date of the statute. *Reinecke* v. *Smith*, 289 U. S. 172, 175. This Court has repeatedly recognized the power of Congress, in accordance with its established practice, to make income tax statutes retroactive for a limited period. *United States* v. *Hudson*, 299 U. S. 498, 500; see *Welch* v. *Henry*, 305 U. S. 134, 146–150; *Milliken* v. *United States*, 283 U. S. 15, 21. The real complaint of petitioner is that the statute in question was enacted in May instead of in the preceding December. Clearly, the extent of the retroactivity under the circumstances is within the limits held permissible in the cited cases.

2. *Hoeper* v. *Tax Commission*, 284 U. S. 206, on which petitioner relies (Br. 21), was concerned with an attempt to tax income arising from property to one who at no time had either title or control over the property or its income. It clearly bears no resemblance to the instant case. See *Whitney* v. *Tax Commission*, No. 541, October Term, 1939; *Burnet* v. *Leininger*, 285 U. S. 136, 142. The petitioner as grantor of the five trusts here retained dominion and control over the corpus as extensive, to say the least, as that which has been held to justify a tax in numerous cases before this Court. See, *e. g.*, *Helvering* v. *Clifford*, 309 U. S. 331; *Du Pont* v. *Commissioner*, 289 U. S. 685, 689; *Reinecke* v. *Smith*, 289 U. S. 172, 178.

Nor is the principle announced in *Eisner* v. *Macomber,* 252 U. S. 189 (Br. 21), applicable here; no problem of defining income is involved. The issue here is whether Congress has power to allocate admitted income to one who retains so many of the attributes of ownership over the property producing the income. The decided cases leave no doubt that it has.

CONCLUSION

The application of the statute here is plainly constitutional under the principles laid down by this Court. There is no conflict of decisions. The petition, accordingly, should be denied.

Respectfully submitted.

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AUGUST 1940.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 166. REVOCABLE TRUSTS.
>
> Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—
>
> (1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or
>
> (2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom,
>
> then the income of such part of the trust shall be included in computing the net income of the grantor. [U. S. C., Title 26, Sec. 166].

Treasury Regulations 86 (as amended by T. D. 4629, XV–1 Cum. Bull. 140, 141–142 (1936), and T. D. 4759, 1937–2 Cum. Bull. 117, 118):

> ART. 166–1. *Trusts with respect to the corpus of which the grantor is regarded as remaining in substance the owner.*—(*a*) If the grantor of a trust is regarded, within the meaning of the Act, as remaining in substance the owner of the corpus thereof, the income therefrom is not taxable in accordance with the provisions of sections 161, 162, and 163 but remains attributable and taxable to the grantor. This article deals with the taxation of such income. As used in this article, the term "corpus" means any part or the whole of the property, real or personal, constituting the subject matter of the trust.

(*b*) Section 166 defines with particularity instances in which the grantor is regarded as in substance the owner of the corpus by reason of the fact that he has retained power to revest the corpus in himself. For the purposes of this article the grantor is deemed to have retained such power if he, or any person not having a substantial interest in the corpus or the income therefrom adverse to the grantor, or both, may cause the title to the corpus to revest in the grantor. If the title to the corpus will revest in the grantor upon the exercise of such power, the income of the trust is attributed and taxable to the grantor regardless of—

(1) whether such power or ability to retake the trust corpus to the grantor's own use is effected by means of a power to revoke, to terminate, to alter or amend or to appoint;

(2) whether the exercise of such power is conditioned on the precedent giving of notice, or on the elapsing of a period of years, or on the happening of a specified event;

(3) the time at which the title to the corpus will revest in the grantor in possession and enjoyment, whether such time is within the taxable year or not, or whether such time be fixed, determinable, or certain to come;

(4) whether the power to revest in the grantor title to the corpus is in the grantor, or in any person not having a substantial interest in the corpus or income therefrom adverse to the grantor, or in both. A bare legal interest, such as that of a trustee, is never substantial and never adverse;

(5) when the trust was created.

But the provisions of section 166 are not

to be regarded as excluding from taxation to the grantor the income of other trusts, not specified therein, in which the grantor is, for the purposes of the Act, similarly regarded as remaining in substance the owner of the corpus. The grantor is regarded as in substance the owner of the corpus, if, in view of the essential nature and purpose of the trust, it is apparent that the grantor has failed to part permanently and definitively with the substantial incidents of ownership in the corpus.

In determining whether the grantor is in substance the owner of the corpus, the Act has its own standard, which is a substantial one, dependent neither on the niceties of the particular conveyancing device used, nor on the technical description which the law of property gives to the estate or interest transferred to the trustees or beneficiaries of the trust. In that determination, among the material factors are: the fact that the corpus is to be returned to the grantor after a specific term; the fact that the corpus is or may be administered in the interest of the grantor; the fact that the anticipated income is being appropriated in advance for the customary expenditures of the grantor or those which he would ordinarily and naturally make; and any other circumstances bearing on the impermanence and indefiniteness with which the grantor has parted with the substantial incidents of ownership in the corpus.

Thus the grantor is regarded as being in substance the owner of the corpus if, in any case, the trust amounts to no more than an arrangement whereby the grantor, in the ordering of his affairs, finds it expedient to entrust for a period the title to, and custody or management of, certain of his property to a trustee, the income from such property to

be used by the trustee during such period to make those expenditures which the grantor would customarily or ordinarily or naturally make and to which the grantor chooses to commit himself in advance, while the corpus is to be held intact, for return in due course to the grantor. In such a case, it is immaterial that, at the time of the creation of the trust, an irrevocable disposition or consummated gift was made of those property rights which consist of the right to the expected future income of the corpus for the specified period. On the other hand, if the grantor, incident to a definitive and permanent disposition of certain of his property, creates the trust in order to conserve the property, not for himself but for the donees, who will ultimately enjoy it, the provisions of sections 161, 162, and 163 are applicable.

(*c*) For example, a grantor is regarded as remaining in substance the owner of the corpus of the trust, if he has placed it in trust for his son, John.

(A) for the term of three years, at the end of which time the trust might be extended for a like period at the option of the grantor and successively thereafter, but in the absence of such an extension the title is once more to revest in the grantor in possession and enjoyment; or

(B) for the term of a year and a day, then to be distributed to whomsoever the wife of the grantor shall by deed appoint (the wife not having a substantial adverse interest in the disposition of the corpus or the income therefrom); or

(C) for the term of the grantor's life, then to be distributed to John, the grantor reserving, however, the right to alter, amend, or revoke any provision of the trust instrument, upon notice of a year and a day.

In these typical cases the grantor is regarded as having retained the substantial incidents of ownership with respect to the income-producing property since the corpus will or may once more revest in himself in (A) upon the expiration of the trust period if the grantor does not exercise his option to extend the trust, in (B) upon the designation of the grantor as distributee, by a person not substantially and adversely interested, and in (C) upon the revocation of the trust instrument or an alteration or amendment thereof, resulting in the designation of the grantor as distributee.

(*d*) If the grantor is regarded as remaining in substance the owner of the corpus the gross income of such corpus shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to the corpus as he would have been entitled to had the trust not been created.

If the grantor strips himself of the substantial incidents or attributes of ownership in the corpus retained by him so that he ceases to be regarded as in substance the owner of the corpus, the income thereof realized after the effective date of such divesting is not taxable to the grantor but is taxable as provided in sections 161, 162, and 163.

A person may have an interest that is both substantial and adverse to the grantor in the disposition of only part of the corpus or the income therefrom. If the power to revest title in the grantor is vested in him in conjunction with such person, or is vested solely in such person, there is to be excluded in computing the net income of the grantor only the income of such part.

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